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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
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IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC. A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.

DOCKET NO. T-01051B-99-0105

AT&T COMMUNICATIONS OF THE MOUNTAIN STATES, INC.'S NOTICE OF FILING TESTIMONY

AT&T Communications of the Mountain States, Inc. hereby files the Testimony of Arleen M. Starr, Lee L. Selwyn, Susan M Gately in the above-referenced matter.

RESPECTFULLY SUBMITTED this 13th day of November, 2000.

AT&T COMMUNICATIONS OF THE MOUNTAIN STATES, INC.

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CERTIFICATE OF SERVICE

I hereby certify that the original and 10 copies of Notice of Filing Testimony of Arleen M. Starr, Lee L. Selwyn and Susan M. Gately were filed this 13th day of November, 2000, with:

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AZ CORP COMMISSION
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BEFORE THE

ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC. FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES	)	Docket No. T-01051B-99-0105

TESTIMONY OF

ARLEEN M. STARR

PUBLIC VERSION

ON BEHALF OF

AT&T COMMUNICATIONS OF THE

MOUNTAIN STATES, INC.

NOVEMBER 13, 2000

I. BACKGROUND AND PURPOSE OF TESTIMONY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Arleen M. Starr. My business address is 1875 Lawrence Street, Denver, Colorado 80202.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A. Yes. I filed direct testimony on August 9, 2000 and surrebuttal testimony on September 8, 2000.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to respond to the Settlement Agreement and supporting testimony filed by the Arizona Corporation Commission Utilities Division Staff ("Staff") and Qwest Corporation, formerly U S WEST Communications, Inc., which is intended to settle all outstanding issues in this proceeding. My testimony focuses specifically on intrastate access services. Mr. Lee L. Selwyn and Ms. Susan M. Gately will comment on additional issues contained in the Settlement Agreement on behalf of AT&T.

Q. PLEASE BRIEFLY OUTLINE YOUR RECOMMENDATIONS.

A. My recommendations are that: (1) access rates for local switching and transport be set at forward-looking economic cost; and (2) the Carrier Common Line Charge "(CCLC)" and the Interconnection Charge ("IC") be eliminated. At a minimum, the Settlement Agreement must include reductions that transition Qwest's intrastate switched access rates to its interstate rates over the initial term of the plan, but certainly no longer than five years.

II. SETTLEMENT AGREEMENT – INTRASTATE ACCESS

Q. WHAT COMMITMENTS, RELATED TO INTRASTATE SWITCHED ACCESS, ARE CONTAINED IN THE SETTLEMENT AGREEMENT?

A. The Settlement Agreement includes a $5 million decrease in intrastate switched access charges for the first year of the agreement. In addition, the Settlement Agreement states that rates for intrastate switched access shall be reduced at the start of the second year of the Price Cap Plan to cause an additional $5 million reduction in revenues from that service, and reduced again at the start of the third year of the Price Cap Plan to cause an additional $5 million reduction in revenues.[1] To offset the $5 million reduction in year two and the $5 million reduction in year three, the revenues available under the cap for Basket 3 Services (Flexibly-Priced Competitive Services), may be increased by $5 million at the start of the second year of the Price Cap Plan, and an additional $5 million at the start of the third year of the Price Cap Plan.[2] This will increase the available revenue in Basket 3 to $35.3 million in year three.

Q. PLEASE QUANTIFY THE EFFECT OF THE INTRASTATE SWITCHED ACCESS REDUCTIONS CONTAINED IN THE SETTLEMENT AGREEMENT?

A. The current intrastate switched access rate in Arizona is 4.5 cents per access minute of use ("amou").[3] Qwest's current intrastate switched access rates are further elaborated on in my direct testimony at pages 12 through 14. The $5 million reduction in the first year of

[1] Notice of Filing of Settlement Agreement at 3.
[2] Notice of Filing of Settlement Agreement at 3.
[3] *U S WEST Rate Case Application*, Testimony of Barbara M. Wilcox (adopted by Scott McIntyre) at 5. 4.5 cents is the switched access average weighted rate per minute.

the plan would reduce the rate to 3.9 cents per amou. The combined $15 million reduction over the three year term of the plan would result in a rate for intrastate switched access of 3.3 cents per amou. On a conversation minute of use ("cmou") basis, this is approximately 6.6 cents.[4] In terms of total dollars, Qwest's current intrastate revenue stream is approximately *[Proprietary] [$XXXXXXXX]*. With the cumulative $15 million reduction over the three year term of the Price Cap Plan, Qwest's intrastate revenue stream would be approximately *[Proprietary] [$XXXXXXX]*.

Q. ARE THE ACCESS REDUCTIONS CONTAINED IN THE SETTLEMENT AGREEMENT SUFFICIENT?

A. No. Switched access rates should be set at forward-looking economic cost. AT&T's full proposal on the specific rates for switched access are outlined in detail in my direct testimony at pages 8 through 11 and pages 33 through 34. In that testimony, I provide the Commission with estimates of the cost of the local switching and transport based on the rates developed by the Commission in the unbundled network element ("UNE") cost proceeding and also using Qwest's interstate access rates. The reductions to switched access contained in the Settlement Agreement do not come close to where they should be — forward-looking economic cost. The reductions to intrastate switched access contained in the Settlement Agreement may be a step in the right direction, but a very small step.

[4] A conversation minute-of-use includes both originating and terminating access charges, together with rate elements associated with call set-up. It should be distinguished from an "access minute of use," which includes only originating or terminating access (not both), and does not include rate elements associated with call set-up.

Much more needs to be done to get access to the level it should be — forward-looking economic cost.

Q. AS A COMPARISON PLEASE PROVIDE INFORMATION ON RECENT COMMITMENTS MADE BY QWEST FOR ACCESS REDUCTIONS IN OTHER STATES?

A. In New Mexico, Qwest recently signed a stipulation settling several outstanding dockets, including its pending rate case, Utility Docket 3008.[5] In this stipulation, Qwest committed to reducing access rates by $14 million over a three year period. Qwest's current intrastate access revenue in New Mexico is approximately *[Proprietary] [$XX XXXXX]*, resulting in a *[Proprietary] [XXX]* decrease in access rates over the three year period. This compares to Qwest's commitment for reductions in intrastate switched access rates in Arizona of $15 million over a three year period on a base of *[Proprietary] [$XXXXXXX]*, a *[Proprietary] [XXX]* decrease. There seems to be some inequity in Qwest's commitment in Arizona relative to what it is willing to do in other states.

Q. WHAT ARE THE SPECIFIC INTRASTATE ACCESS RATES WHICH WILL BE REVISED AS A RESULT OF THE $5 MILLION ACCESS REDUCTION WHICH IS SCHEDULED TO TAKE PLACE IN THE FIRST YEAR OF THE AGREEMENT?

A. Based on the rate elements and corresponding rate revisions provided in Attachment B to the Settlement Agreement, Qwest will reduce the CCLC revenue by approximately $1.189

[5] The stipulation is currently before the New Mexico Commission for approval.

million, or 4.3%, reduce the IC by $5 million, or 60.6% and increase the transport rate elements by approximately $1.170 million, or 22.5%. The net reduction of $5 million is a 7.1% reduction in intrastate switched access revenue. Both the CCLC and the IC are rate elements that are unrelated to any services provided to Interexchange Carriers ("IXCs") to enable the IXCs to provide toll services. These rate elements have no cost basis, are a subsidy to Incumbent Local Exchange Carriers ("ILECs") like Qwest, and should be eliminated. Additional comments on the CCLC and the IC are provided in my direct testimony at pages 19 through 21. After the first reduction in year one, the CCL intrastate revenue remains at approximately *[Proprietary] [$XXXX]* million and the IC intrastate revenue remains at approximately *[Proprietary] [$XXX]* million, or almost *[Proprietary] [$XXXXXXX]* for the two non-cost based rate elements.

The increase in transport is the result of adding four new rate elements: common transport multiplexing, tandem trunk port, end office dedicated trunk port and end office shared port. Qwest is adding these new transport elements to more closely align the Arizona intrastate transport rate structure with the interstate transport rate *structure*, but not to the interstate rate *levels*. This is more fully elaborated on in my direct testimony at pages 16 through 19. Additionally, a comparison of Qwest's proposed intrastate switched access rates, including the proposed revisions in year 1, to its interstate switched access rates was provided in Revised Exhibit AS-1. This exhibit demonstrates the magnitude the intrastate switched access rates are above the interstate switched access rates.

Q. DOES THE SETTLEMENT AGREEMENT CONTAIN ANY DETAIL ON HOW THE $5 MILLION INTRASTATE ACCESS REDUCTION IN YEAR TWO AND THE $5 MILLION ACCESS REDUCTION IN YEAR THREE WILL TAKE PLACE?

A. No. The Settlement Agreement does not provide any detail on what specific rate elements will be revised in order to effectuate the $5 million access reductions in years two and three. These reductions should first be directed first to the non-cost based access elements, the IC and the CCLC. Even with the additional $10 million in reductions directed toward these rate elements, this would still leave approximately *[Proprietary] [$XXXXXXX]* in revenue from this source.

Q. IS THERE ANY LANGUAGE CONTAINED IN THE SETTLEMENT AGREEMENT WHICH STATES WHEN INTRASTATE SWITCHED ACCESS RATES IN ARIZONA WILL BE REDUCED TO INTERSTATE LEVELS?

A. No. The Settlement Agreement states that the objective for intrastate switched access is parity with interstate switched access rates.[6] Additionally, the testimony of Harry M. Shooshan III on behalf of Staff states that, the Settlement Agreement "lowers charges made by Qwest to long-distance carriers by $15 million over the three years (and eventually to the interstate level)."[7] AT&T supports the reduction of intrastate switched access rates in Arizona to interstate levels as a minimum first step to reducing access rates to forward-looking economic cost, but this Settlement Agreement does not contain any

[6] Settlement Agreement, Attachment A at 3.
[7] Testimony of Harry M. Shooshan III at 7.

language obligating Qwest to reduce intrastate switched access rates to interstate levels, by a specific date. Qwest's proposed "objective" is worthless. The terms of the Settlement Agreement guarantee that intrastate switched access rates in Arizona will not be reduced anywhere near interstate levels for at least three years, the term of the plan.

The $15 million access reduction over the three years is a miniscule step for intrastate access rates to reach the interstate level. To reach interstate revenue levels, intrastate rates must be reduced from their present levels by approximately *[Proprietary] [$XX XXXXXX]*. As stated previously, the combined $15 million reduction over the three year term of the plan would result in a rate for intrastate switched access of 3.3 cents per amou. Qwest's current interstate access rate is approaching .005 cents per amou — a very long way from 3.3 cents. The target interstate switched access rate of .055 cents more closely reflects the underlying cost of providing this switched access service, and of course there is no difference between the cost of providing intrastate and interstate switched access. On that basis, the existing 4.5 cent switched access rate is set at nine times its cost, and the 3.3 cent intrastate switched access rate that will exist after the year three $5 million rate decrease will be six times the underlying cost. Moreover, Qwest's interstate access rates will continue to decrease as it continues to implement changes in interstate access rates as a result of the adoption of the Coalition for Affordable Local & Long Distance Service Plan ("CALLS").[8] Neither the present nor the Settlement Agreement switched access rate

[8] *In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Low-Volume Long Distance Users and Federal-State Joint Board on Universal Service*, CC Docket 96-262, et al., Sixth Report and Order in CC Docket 96-262 and 94-1, Report and Order in CC Docket 99-249, and Eleventh Report and Order in CC Docket 96-45 (May 31,2000).

level is economically reasonably, and the original Staff proposal should be substituted for the access reductions included in the Settlement Agreement in order to assure just and reasonable access and intrastate toll rates.

Q. DO YOU RECOMMEND THAT INTRASTATE SWITCHED ACCESS RATES BE REDUCED TO INTERSTATE RATES DURING THE TERM OF THE PLAN?

A. Yes, at a minimum. The ultimate goal for all access rates, intrastate and interstate, should be forward-looking economic cost. Transitioning Qwest's intrastate switched access rates to its interstate levels is movement towards that goal and is purportedly one of the goals of the Settlement Agreement. Moreover, reducing intrastate switched access rates to Qwest's interstate rates over a fixed period of time was originally advanced by Staff. Staff's original proposal stated:

> I propose that intrastate access prices be reduced by 20 percent per year from their initial levels so that by the end of the initial five year period [of the price regulation plan that was proposed in the initial pre-Settlement testimony] they are equivalent to U S WEST's interstate access charges at July 2000 levels. From that point on, I recommend that intrastate access charges be adjusted to "mirror" the interstate rates.[9]

This recommendation was both reasonable and generally consistent with the approach that has been adopted in the CALLS settlement, i.e. five-year transition to cost-based access charges. It would, at the end of the transition period, essentially eliminate the existing disparity between Arizona intrastate and interstate switched access charges, and make it possible for intrastate toll (and particularly intraLATA toll) competition to develop to the same robust level that prevails in the case of interstate toll services. It appears that Staff,

[9] Direct Testimony of Harry M. Shooshan III at 12.

without any explanation, has abandoned its original proposal in favor of a more ambiguous proposal that is more favorable to Qwest.[10]

Q. HOW IS INTRASTATE SWITCHED ACCESS TREATED IN TERMS OF THE PRICE CAP PLAN?

A. Intrastate switched access service is included in Basket 2, Wholesale Services. Wholesale services are essentially not under a Price Cap Plan. The Settlement Agreement states that services included in Basket 2 will be governed by their own specific pricing rules and will continue to be governed by such rules. The Settlement Agreement states the exception to this is intrastate switched access, which will be reduced by $5 million per year for the duration of the initial term of the plan.[11] Mr. Selwyn provides additional information as to the problems associated with having retail services in Basket 1 under a Price Cap Plan, while wholesale services in Basket 2 are not under a Price Cap Plan.

Q. DOES THE SETTLEMENT AGREEMENT INCLUDE ANY MODIFICATIONS TO ACCESS RATES OTHER THAN THE $5 MILLION PER YEAR REDUCTION OVER THE THREE YEAR TERM OF THE PLAN?

A. The Settlement Agreement does not contain any information indicating what will happen with intrastate access rates at the end of the three year term of the plan, either if it is

[10] It should be noted that Qwest is seeking Section 271 relief in Arizona. Staff's new proposal allows Qwest to retain substantial subsidies and permits price squeezes. Staff's original proposal would have eliminated most of the subsidies in Qwest switched access rates, thereby reducing the severity, although not eliminating, the potential price squeezes.

[11] Settlement Agreement, Attachment A at 3.

renewed or terminated.

Q. DOES THE SETTLEMENT AGREEMENT CONTAIN ANY INFORMATION ON ACC PRICING RULES AS IT RELATES TO BASKET TWO SERVICES?

A. Yes. The Settlement Agreement states that nothing in the Price Cap Plan is intended to change or modify in any way the imputation requirements contained in A.A.C. R14-1-1310.[12]

Q. DOES AT&T SUPPORT THE INCLUSION OF THIS LANGUAGE REQUIRING IMPUTATION IN THE PRICING OF SERVICES?

A. Yes. Although, it is necessary to include this language in Basket 3, Flexibly-Priced Services. The most significant issue related to pricing is imputing the price of all essential facilities in Qwest's toll services, including switched access. Since toll services are in Basket 3, this language should be included in the requirements of Basket 3. See pages 28 through 33 of my direct testimony explaining the importance of imputation requirements and the potential price squeeze opportunities Qwest has in the intraLATA toll market in Arizona relative to its competitors.

Q. WHAT ADDITIONAL ISSUES ARISE RELATIVE TO ACCESS SERVICES DUE TO THE PRICE CAP PLAN?

A. While the Settlement Agreement includes reductions in switched access rates of $15 million over the three year term of the plan, $10 million of this reduction is moved to

[12] Settlement Agreement, Attachment A at 3.

Basket 3 by increasing the revenue cap for services in Basket 3. Basket 3 includes services that have been granted pricing flexibility or have been determined by the Commission to be competitive under A.A.C. R14-2-1108.[13] These include: U S WEST DS1 Service, U S WEST DS3 Service, Switched Transport and Switched Access Service (DS1 &DS3).[14] The $10 million reductions in intrastate switched access rates in years two and three could result in increases in rates for access services contained in Basket 3. The result of this would be no *real* decrease in rates for carriers purchasing access services from Qwest.[15] Moreover, it seems somewhat illogical to increase the revenue cap in Basket 3 by $10 million. Basket 3 is for competitive services that have been granted pricing flexibility. It would seem that prices for competitive services would be going down, not up; making the potential $10 million increase in rates for these services unnecessary or their classification as competitive suspect.[16]

III. CONCLUSION

Q. WHAT DO YOU RECOMMEND THAT THE ARIZONA COMMISSION ORDER IN THIS PROCEEDING?

A. There are several things this Commission needs to order. These include:

[13] Settlement Agreement, Attachment A at 3.

[14] Settlement Agreement, Attachment E.

[15] Qwest could simply raise its private line and special access rates. Although the Commission determined that these services are competitive, in reality, there is little competition for these services. IXCs must still buy the bulk these services from Qwest.

[16] Also included in Basket 3 are all new services and new service packages offered by Qwest, allowing the $10 million increase in the revenue cap to go to new services. This will be discussed in further detail in the testimony of Mr. Selwyn.

- Set access rates at forward-looking economic cost equivalent to the UNE rates established by the Commission in the cost proceeding in Arizona for local and tandem switching and equal to U S WEST's interstate rates for transport;

- At a minimum, the Settlement Agreement must include reductions that transition Qwest's intrastate switched access rates to its interstate rates over the initial term of the plan, but certainly no longer than five years;

- Eliminate the Carrier Common Line Charge and the Interconnection Charge, which have no cost basis and are merely subsidies being provided to Qwest by IXCs at the ultimate expense of end users;

- Implement the recommended adjustments to the revenue requirement contained in the testimony of Ms. Gately; and

- Make modifications to the Price Cap Plan as outlined in the testimony of Mr. Selwyn.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

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Before the

ARIZONA CORPORATION COMMISSION

In the Matter of the Application of US West Communications, Inc., a Colorado Corporation, for a Hearing to Determine the Earnings of the Company, the Fair Value of the Company for Ratemaking Purposes, to Fix a Just and Reasonable Rate of Return thereon and to Approve Rate Schedules Designed to Develop Such Return	**Docket No. T-1051B-99-0105**

Supplemental Direct Testimony

of

LEE L. SELWYN

on behalf of

AT&T COMMUNICATIONS
OF THE MOUNTAIN STATES, INC.

November 13, 2000

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SUPPLEMENTAL DIRECT TESTIMONY

Introduction

Q. Please state your name, position, and business address.

A. My name is Lee L. Selwyn. I am president of Economics and Technology, Inc., One Washington Mall, Boston, Massachusetts 02108.

Q. Are you the same Lee L. Selwyn who has previously filed direct and surrebuttal testimony in this proceeding?

A. Yes. I prepared direct testimony that was filed on August 8, 2000 and surrebuttal testimony that was filed on September 8, 2000.

THE PROPOSED QWEST/STAFF SETTLEMENT AGREEMENT

The "compromise" that is reflected in the proposed Settlement Agreement is not based upon any specific ratesetting principles and ignores entirely contrary evidence that has been offered in this proceeding.

Q. Dr. Selwyn, have you reviewed the "Settlement Agreement" entered into by Qwest and the Commission's Staff and the testimony offered by both parties in support thereof?

A. Yes, I have.

Q. Will the proposed Settlement Agreement, if adopted by this Commission, result in just and reasonable rates?

A. No, it will not. As readily conceded by Staff witness Brosch, "there was no issue-by-issue negotiation and the total revenue requirement that was agreed upon is not premised upon specific outcomes for particular issues. *The Settlement Agreement should not be viewed as an agreement regarding any theories or positions that are at issue in this Docket.* Rather, the Settlement is a compromise of all of the issues between Staff and the Company."[1] Unfortunately, this "compromise" is so distant and disconnected from the evidence that has been offered in this proceeding that there is no basis upon which the Commission can properly evaluate the "justness and reasonableness" of the rate level and rate structure that the Settlement Agreement contemplates.

1. Brosch (Staff), Supplemental Testimony at 1-2, emphasis supplied.

Ms. Gately addresses the proposed $42.9-million in rate increases, and demonstrates that in accepting this "compromise" the Staff has ignored compelling evidence that, in fact, Qwest's rates overall should be *reduced*, not increased. The proposed price cap regulation plan, which calls for a productivity offset or "X" factor to be applied to a limited number of Qwest services, with other rates either being frozen or permitted to rise by as much as 10% annually during the three-year term of the plan, is unduly generous to Qwest, will result in excessive and unreasonable rates for certain "Basket 3" services that do not confront effective, price-constraining competition, and by freezing "Basket 2" rates at their existing levels, will impose a price squeeze upon competing local carriers. Finally, the proposed rate design, together with the "Basket" structure of the proposed price cap plan, will result in excessive and unreasonable rates for many Qwest services. Like the rest of the Settlement Agreement, this rate design is devoid of basis or principle.

Q. What is your overall recommendation to this Commission with respect to the proposed Settlement Agreement?

A. The Settlement Agreement as presented should be rejected. It may be possible to modify the Agreement so as to eliminate some of its more blatant deficiencies but, since the Agreement itself precludes such modification,[2] the Commission should permit the various contested issues to be litigated.

2. Settlement Agreement, at 8.

The proposed price cap regulation system will result in inadequate rate decreases for the "Basket 1" services to which the X-factor will apply, and will produce excessive rates for services classified in "Baskets" 2 and 3.

Q. What exactly is "price cap regulation," and how does it operate to produce just and reasonable rates?

A. Under rate-of-return regulation (RORR), the aggregate rate level is set based upon a "revenue requirement" that is comprised of the utility's operating expenses including depreciation on its capital assets, plus a "competitive return"[3] on its invested capital. *Price cap regulation*, by contrast, is intended to *disconnect* prices from costs, substituting in place of company-specific costs a *projected* cost level that is based upon the economywide inflation rate less an offset that reflects ILEC *industry-wide* productivity growth experience. Assuming that the productivity offset has been properly set, over time an ILEC subject to price caps should continue to earn the RORR "competitive rate of return" if its own productivity experience is the same as the industry as a whole, should see an increase in its rate of return if its productivity growth exceeds the industry level, and should see an erosion in its earnings if its performance falls below industry levels.

Q. How does price cap regulation benefit ratepayers?

3. Generally, a "competitive return" is one that would be realized from an investment in a nonregulated competitive enterprise with risk and liquidity that is comparable to that characteristic of a public utility subject to rate-of-return regulation, where the utility can expect to be "made whole" with respect to earnings erosion and various other business losses.

A. Price caps is a form of "incentive regulation" in which the ILEC is rewarded for superior efficiency and penalized for inefficiency, as measured by an industry-wide standard. Presumably, this system of "rewards" and "penalties" is supposed to afford the regulated firm an incentive to increase its operating efficiency and produce its services at lower overall cost. However, ratepayers will benefit from the salutary effects of price caps only to the extent that any efficiency gains are ultimately, if not immediately, flowed through in the form of reduced prices.

In principle, that flow-through should be accomplished via the productivity offset factor. However, the calculation of such a factor has been highly controversial; if it is set too low, ILECs realize a windfall gain in earnings that arises not from their own efficiency but rather as a result of the *misspecification* of the productivity offset factor. There are specific devices that have been incorporated into price cap plans to protect against such misspecification. These include, among other things, periodic reviews, "sharing" of excessive earnings with ratepayers, and "low-end adjustment mechanisms" that protect the utility against a misspecification of the productivity offset factor in the opposite direction.

Q. Should utilities subject to price cap regulation be permitted to retain indefinitely the benefits of any efficiency gains that result from the incentive regulation system?

A. No. In competitive markets, firms are able to benefit financially from efficiency or productivity gains only as long as those efficiencies are not replicated by competing firms; in other words, the financial benefits of an efficiency gain are temporary at best.

If under price cap regulation a utility is enabled to generate *consistent* supracompetitive profits, there is strong reason to suspect that the price cap offset factor has been *misspecified* rather than that the ILEC's productivity gains have been so spectacular.

Q. What can be done to overcome this problem?

A. Three things. First, the productivity offset factor must be correctly calculated and accurately specified. Second, some default mechanism, such as the sharing with ratepayers of excessive earnings, should be put in place so as to protect against misspecification. Finally, the price cap plan should be subject to periodic reviews and *reinitialization* of rates at a "competitive" rate of return, as well as a possible adjustment in the productivity offset factor, based upon the performance of the utility during the term of the price cap plan.

Q. But doesn't this cut both ways — what if the ILEC's earnings erode under a price cap regime?

A. The ILEC always has the ability to come back to the Commission and ask for extra-ordinary relief or even a return to RORR. Ratepayers, on the other hand, would have no specific mechanism to seek relief in the event of excessive earnings, except through a review type of proceeding or through some preestablished device, such as sharing.

Q. To what productivity offset factor is Qwest subject with respect to its *interstate* services?

A. The FCC has established a productivity offset or so-called "X" factor of 6.5%.[4] The 6.5% X-factor that was adopted by the FCC for *interstate* services is based upon *unseparated* total company productivity results; indeed, the United States Telephone Association (USTA) and the various ILECs participating in the FCC price cap proceedings — *including Qwest's predecessor US West* — have consistently argued that jurisdiction-specific results are not economically meaningful because, they claim, any cost separation would necessarily be arbitrary. While I personally disagree with that conclusion and have so stated on numerous occasions,[5] the fact remains that the FCC has adopted the USTA/ILEC position on this subject. Now, if the Arizona Commission were to adopt a different, and lower, X-factor than that adopted by the FCC — which is precisely what the Staff has recommended and which the Settlement Agreement expressly contemplates — the result would be a windfall gain for Qwest. Accordingly, since the cost conditions extant in the federal jurisdiction are *by definition* identical to and inseparable from those extant at the state level (by virtue of the FCC's decision, supported by Qwest, to base the interstate X-factor upon total company unseparated

4. FCC, *In the Matter of Price-Cap Performance Reviews for Local Exchange Carriers*, CC Docket No. 94-1, Fourth Report and Order, Para. 141, 12 FCC Rcd 16642, 16697 (1997).

5. Lee L. Selwyn and Patricia D. Kravtin, *Establishing the X-Factor for the FCC long-term LEC price cap plan*, FCC CC Docket 94-1, on behalf of the Ad Hoc Telecommunications Users Committee, December, 1995, at 48-49; Lee L. Selwyn and Patricia D. Kravtin, *Reply to X-Factor Proposals for the FCC Long-Term LEC Price Cap Plan*, FCC CC Docket 94-1, on behalf of the Ad Hoc Telecommunications Users Committee, March, 1996, at 6; In the Matter of the Application of Bell Atlantic - New Jersey for Approval of A Modified Plan for an Alternative Form of Regulation and to Reclassify All Rate Regulated Services as Competitive Services, Rebuttal Testimony of Lee L. Selwyn on behalf of the State of New Jersey Division of Ratepayer Advocate, September 8, 2000, at footnote 32, p. 32.

productivity results), there is no basis for this Commission to adopt a different productivity offset factor than the one adopted by the FCC.

Q. What are your specific objections to the price cap plan that is contained in the Settlement Agreement?

A. There are several serious deficiencies that should render the proposed plan unacceptable. First, the plan itself, while portrayed as a major departure from the traditional rate-of-return regulation (RORR) to which Qwest is presently subject, continues to offer Qwest the principal *protections* of rate-of-return regulation while permitting and affording the Company the means to achieve a potentially significant increase in its earnings. The short duration of the plan — only three years — coupled with the expectation that any adjustments that may be made after three years will be based upon a productivity "study" to be conducted by Qwest itself, essentially afford Qwest the ability to claim a revenue shortfall and revert to rate-of-return regulation (or adjust the productivity offset factor to accomplish the equivalent result) in the event that Qwest's earnings erode under the Settlement. On the other hand, if Qwest is able to increase its earnings above the level that would otherwise be authorized under RORR, it would be permitted to retain those excessive earnings without a requirement that they be shared with ratepayers or that rates be reduced to eliminate the excess. As drafted in the Settlement, the price cap plan amounts to a "heads I win, tails you lose" arrangement for Qwest, providing no assurance that the rates that will actually materialize under this plan will come even remotely close to satisfying the "just and reasonable" standard as expressly required by Ariz. Const. Art. 15 §3.

Q. What are the specific defects that you believe exist in the price cap plan that is contemplated in the Settlement Agreement?

A. The first issue relates to the proposed 4.2% X-factor. Staff had originally recommended adoption of a 4.2% X-factor based upon the 3.7% productivity growth rate developed by Staff witness Harry M. Shooshan based upon Qwest data,[6] plus a 0.5% "Consumer Productivity Dividend" ("CPD").[7] Staff apparently conducted no independent productivity study. Instead, it relied upon expense and revenue data supplied by Qwest,[8] and developed an average productivity growth rate for the period 1995 through 1998. Productivity growth is calculated by comparing the change in the dollar expenditure on *inputs* (capital, labor and materials) to the change in the dollar value of *outputs* (the products and services that Qwest produces and sells). The extent to which output (as defined by revenues) growth exceeds input growth represents the *productivity gain* for that particular year. The productivity growth for those four years, according to the Qwest data relied upon by the Staff, was 4.4%, 4.5%, 4.3% and 1.6%, respectively, for 1995, 1996, 1997 and 1998. No explanation is offered for the dramatic drop that was experienced in 1998. More importantly, there was no attempt to analyze the *input* growth

6. Shooshan (Staff), Direct Testimony, at 14.

7. *Id.*

8. See Staff's response to AT&T 1-001.

— particularly the capital investment input — to determine the extent to which it is being driven by *monopoly* (Basket 1 and Basket 2) services or by "*competitive*" (Basket 3) services. There is, in fact, a strong likelihood that much of Qwest's recent capital purchases have been driven by the desire to upgrade the Arizona network to accommodate various new services, such as DSL, which would be classified in Basket 3.

Q. Is there anything wrong with the Company pursuing such an investment strategy?

A. No, and in fact such investments and infrastructure upgrades will benefit the Arizona economy and Arizona ratepayers. The problem is that such capital outlays have the effect of increasing input growth and in so doing will *depress* the resulting productivity growth calculation because the capital investments will necessarily precede the ramp-up of revenues. The sharp drop in calculated productivity growth for 1998 vs. 1995-1997 may well be entirely attributable to this phenomenon.

Q. What is the solution to this problem?

A. As long as the resulting price cap index is to apply to only a limited number of Qwest services — in the case of the Settlement Agreement, to Basket 1 services only — it is necessary that productivity growth be calculated solely with respect to the services to which the X-factor is to apply. Thus, capital investments and other expenditures, along with associated revenues, that are directly associated with Basket 3 services should be *excluded* from the productivity calculation that is then used to develop the *Basket 1* X-factor. Alternatively, if the X-factor is developed across the entire Company service mix, as is the case with the Staff's calculations, then the resulting X-factor must be applied across *all* of the services over which it was calculated.

Q. The US Court of Appeals for the District of Columbia (Court) has since remanded this decision back to the FCC.[9] Why should the Arizona Commission give this 6.5% number any weight?

A. The Court did not reject the underlying studies or model upon which the FCC relied.[10] The Court did, however, fault the FCC's justification (as set forth in its written decision) for the specific selection of 6.0% for the productivity factor and 0.5% for the consumer productivity dividend.[11] The FCC Staff developed seven averages of total productivity ranging between 5.1% and 6.1%. My understanding of the Court decision is that it determined that the FCC failed to provide sufficient rationale for its particular selection of 6.0%. The DC Circuit stayed this ruling on June 21, 1999, giving the FCC until April of 2000 to respond to the remand order.[12] The FCC opened a remand proceeding in

9. *United States Telephone Association, et al., v. FCC*, No. 99-1469, (D.C. Cir. May 21, 1999). 188 F.3d 521 (1999), 1999 U.S. App. Lexis 9768.

10. *Id.*, at 529.

11. *Id.*, at 524-525, 527.

12. *United States Telephone Association, et. al, v. FCC,* No. 97-1469 (D.C. Cir. June 21, 1999) (Order granting FCC's motion to stay the mandate).

which X-factors in the range of 5.5% to 8.51% were supported.[13] The FCC has since adopted the CALLS *settlement* plan in lieu of making a specific finding pursuant to the remand.[14] The 6.5% X-factor governs the scheduled reductions in interstate switched access charges set forth in the CALLS plan, effectively settling the price cap (X-factor) issue and locking in the 6.5% value for X.

Q. Did Qwest/US West support the adoption of the 6.5% X-factor as part of the CALLS settlement?

A. Yes. Qwest was a signatory to the CALLS plan, setting in motion a transition to cost-based access charges that would, among other things, retain the 6.5% X-factor until switched access charges reach 0.55 cents per minute for the Bell Companies and GTE, and 0.65 cents per minute for other price cap LECs.[15] Qwest has supported this plan, which incorporated the FCC's 6.5% X-factor in driving the annual price adjustments. In view of the FCC's action in rejecting jurisdiction-specific productivity in favor of a

13. *In the Matter of Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, FCC CC Docket Nos. 94-1, 96-262, Further Notice of Proposed Rulemaking, November 15, 1999 (*Price Cap and Access Reform Further Notice of Proposed Rulemaking*).

14. *Access Charge Reform*, CC Docket No. 96-262, Sixth Report and Order in Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket 96-45, FCC 00-193 (*rel.* May 31, 2000).

15. FCC CC Docket No. 96-262, *In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Low-Volume Long Distance Users, Federal-State Joint Board on Universal Service,* CC Docket Nos. 98-262, 94-1, 99-249, 96-45, *Notice of Proposed Rulemaking,* released September 15, 1999, Appendix C, "Memorandum in Support of the Coalition for Affordable Local and Long Distance Service Plan."

productivity growth factor based upon unseparated total company operations, it is inconsistent and inappropriate for this Commission to adopt an X-factor that is so much less than the 6.5% adopted by the FCC based upon *total company* operating results.

Q. Do you agree with the methodology that Mr. Shooshan utilized in calculating the 3.7% productivity growth rate upon which the 4.2% X-factor was based?

A. No. Mr. Shooshan's methodology is highly simplistic and ignores a broad range of issues, some of which I have already discussed. However, even within the context of his methodology, he appears to have selected the "adjusted revenue" series rather than the "unadjusted revenue" from the same Qwest data set, yet offers no explanation as to what the "adjustment" was or why it should have been used. Revenue represents a monetary measurement of "output" and is, in effect, a *revenue-weighted* measure of *physical* output. There is considerable debate as to the efficacy of utilizing a revenue-weighted output measure, particularly in jurisdictions such as Arizona where local exchange service is generally furnished on a "flat-rate" basis. Growth in the *utilization* of the network — i.e., in the number of minutes of use — will not be tracked by a revenue-based metric where usage is furnished on a flat-rate basis. There are likely other anomalies that work to render the use of a revenue-weighted output measure inappropriate for use in a price cap productivity study.

Q. Have you been able to replicate Mr. Shooshan's calculation using the *unadjusted* revenue series that was contained in the Qwest data?

A. Yes, I have. Substituting the Qwest unadjusted revenue for the adjusted revenue, the productivity growth rate for the period 1995-1999 (the same period studied by Mr. Shooshan) is 4.8% rather than the 3.7% that he had calculated. Attachment 1 to this testimony provides a summary of that calculation.

Q. What would be the X-factor based upon this 4.8% productivity growth rate?

A. Mr. Shooshan has recommended adding a 0.5% "consumer productivity dividend" to his calculated productivity growth rate. On that basis, the X-factor based upon an unadjusted revenue productivity calculation would be 4.8%+0.5%, or 5.3%.

Q. As you have already mentioned, in the FCC's price cap proceeding, the ILECs argued that the Commission should base its productivity growth calculation upon *total company unseparated* operating results, rather than confine it to jurisdictionally *interstate* results, and the FCC accepted that argument. Does the same argument that the ILECs have advanced with respect to not utilizing jurisdiction-specific X-factors also apply with respect to X-factors applicable to services in each of the three "Baskets" contemplated in the Settlement Agreement?

A. Yes, indeed. If one takes the position that separating productivity between intrastate and interstate services is "arbitrary" as Qwest/US West and USTA have done, then exactly the same can be said with respect to rate regulated vs. "competitive" services. Of course, as I have stated, I disagree with the ILECs' and the FCC's determination on this point; in my view, separate productivity results can and should be calculated, both as between interstate and intrastate services, and as between rate regulated and "competitive" services. However, given the ILECs' and the FCC's position on this issue, only a single productivity measure should be calculated across all ILEC services, monopoly as well as competitive.

Q. Is that what the Staff has done here in developing its 4.2% X-factor proposal?

A. Yes, the calculation was made across *all* services, Baskets 1 and 2 monopoly services as well as Basket 3 "competitive" services. There is no indication, in the data supplied by Staff in response to AT&T 1-001, that any attempt was made to limit the productivity calculation only to monopoly services.

Q. What are the implications of this construct for price cap plan that has been incorporated into the Settlement Agreement?

A. It underscores the need to require that in the aggregate *all* services — *monopoly as well as "competitive"* — be subject to the common companywide X-factor. Thus, whatever pricing flexibility may be afforded to Qwest with respect to its Basket 3 "competitive" services should be reflected in monopoly service rates by assuring that the overall rate changes are consistent with the overall price cap.

Q. Why is it important that Basket 3 "competitive" services be included within the application of the overall price cap index?

A. It is likely that productivity growth is higher for monopoly services than for those that have been classified as "competitive" since truly competitive services would tend to exhibit slimmer price margins and would likely involve large product development costs, marketing/advertising and sales expenses, large new capital expenditures, and various other items that would not apply to monopoly services and that will tend to reduce the potential productivity growth in the "competitive" segment of Qwest's output. I have already noted that the precipitous drop in productivity growth in 1998 relative to the immediately preceding three years may well be explained by capital investments aimed at supporting the introduction of services that would be classified as "competitive" and thus exempt from application of the X-factor. In that case, using a companywide productivity growth rate rather than one that had been developed exclusively with respect to monopoly services would produce a lower *apparent* productivity growth rate for the monopoly services, because it would in effect shift costs incurred for the benefit of competitive services to monopoly services.

Q. If as you have suggested the productivity growth rate for truly competitive services is lower than the companywide average and hence lower than the productivity growth rate that would apply for monopoly services were these to be separately studied, what are the implications for the X-factor that would need to be applied to monopoly services only if in fact it is not possible to include "competitive" services within the scope of the price cap index?

A. In that event, the X-factor applicable to monopoly services should be increased to reflect the deaveraged productivity growth rate.

Q. Are you proposing such an adjustment in this case?

A. No, I do not have the basis upon which to perform such a calculation. However, the fact that the X-factor applicable to monopoly services only would necessarily be greater than one derived across all of the Company's services underscores the fundamentally *conservative* nature of the recommendation that I have made, i.e., that the FCC's total company X-factor (whose calculation includes services that Qwest has classified as "competitive") should be adopted for application to Arizona intrastate services.

Q. One seemingly novel aspect of the proposed plan is that notwithstanding the level of inflation, the resulting price cap index cannot be increased above 1.00. Will this feature have the effect of preventing prices from rising if economywide inflation increases?

A. No, it will not. If the economywide inflation rate (GDP-PI) exceeds the 4.2% X-factor, then this constraint would become operative. Of course, the US inflation rate has been running in the 1.5% to 2.5% range for nearly a decade, and so it is highly improbable that this feature of the proposed plan would ever be invoked. Moreover, the specifics of this feature would actually permit the Company increase rates in later years if rate decreases had occurred in previous years. So in fact there may be no real upward price constraint at all.

Q. Please explain.

A. Suppose that the inflation rate in year 1 is 2.0%. Applying the GDP-PI – X formula, the Price Cap Index (PCI) would drop from 1.00 to 0.978. Supposing, however, that in the second year inflation jumps to 6%. In that event, the PCI would actually be increased by (6.0% – 4.2%), or 1.8%, to 0.996. So the "protection" ostensibly being afforded consumers by this capping feature would be effectively neutralized.

Q. What about the 4.2% X-factor itself - is this a reasonable value for X?

A. No. As I have already explained, the 4.2% is based upon total intrastate operations rather than being confined to those services to which the 4.2% X-factor would actually apply. In addition, the Staff's calculation gives no effect to yet another factor that has been expressly adopted by the FCC and by a number of state commissions — the so-called "input price differential."

Q. What is the "input price differential?"

A. The rapid and accelerating pace of technological innovation in the telecommunications industry has resulted in persistent and substantial price *decreases* for the principal capital purchases that are made by local telephone companies, which consist of computer-based electronic digital switching systems (both circuit- and packet-switched) and fiber optic transmission systems, including both the physical fiber optic cable itself and associated electronics. This reduction in "input prices" reflects productivity growth *in the supplier sector*, and should be included within the overall X-factor calculation. LEC input prices are growing at a significantly slower rate than the overall economywide inflation rate. The use of a GDP-PI – X price cap index formula improperly applies the productivity offset to the economywide inflation rate rather than to the cost inflation rate that is actually being experienced by ILECs. Inclusion of the input price differential corrects for this problem.

Q. What specific rationale did the FCC offer for its adoption of an input price differential?

A. During its price cap proceedings, the FCC has found that LECs purchase goods and services (or inputs) whose costs change relative the economy as a whole. If the prices for these goods and services are moving at the same rate as the national economy then these price movements will be reflected in the GNP-PI that is used in determining the price cap index annual adjustment. However, the FCC has concluded that if the inflation factor (GNP-PI) does not accurately reflect changes in a LEC's input costs (because, for example, telecommunications input prices are not rising as fast as prices in the national economy) an X-Factor that does not include an input price differential and is based solely on productivity changes "will not capture the full extent of the differences between changes in LEC unit costs and the economy-wide inflation adjustment."[16] The FCC has consistently concluded that changes in LECs' costs of producing a unit of output are the product of both changes in productivity (or the quantity of resources used) and changes in input prices and as such, "the X-Factor should include both a measure of productivity growth and a measure of input price changes."[17]

Q. Has Qwest accepted an X-factor in excess of 4.2% in any of its other state jurisdictions?

A. Indeed it has. As I noted in my direct testimony, the Utah PSC has proposed a 6.2% value for the X-factor in its price cap formula.[18] In that both Utah and Arizona will

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16. Federal Communications Commission, *In the Matter of Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, First Report and Order, Released April 7, 1995, para. 160.

17. Federal Communications Commission, *In the Matter of Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, CC Docket Nos. 94-1, 96-262, Fourth Report and Order in CC Docket No. 94-1, Second Report and Order in CC Docket No. 96-262, Released May 21, 1997, para. 95.

18. The Public Service Commission of Utah recently issued a proposed rule in Docket 00-352-01 governing the implementation of price caps regulation for Qwest. Proposed Rule Number R746-352 would establish a GDP-PI minus X-factor price cap, with the X-factor set at 6.2% for at least the first year of the plan. (See subsection 4(B)(2) of the proposed rule, available at http://www.psc.state.ut.us/rules/352oct.htm). The language in subsection 4(B)(2) is as follows:

> 2. The productivity factor to be used in calculating the maximum prices for tariffed public telecommunication services pursuant to Section 54-8b-2.4(5) shall be

(continued...)

have established their respective X-factors through settlements rather than through litigation, there seems no reason why Arizona should accept a value for X that differs so dramatically from the value that Qwest had accepted in the adjoining state. Indeed, all else being equal, one would expect that the significantly greater population density characteristic of Arizona relative to Utah would result in larger cost decreases than those experienced in the more rural jurisdiction, suggesting an X-factor that is even greater than 6.2%, such as the 6.5% value adopted by the FCC.

As I have also noted, Qwest has been subject to an X-factor of 6.5% at the federal level since 1997, and by its participation in the so-called "CALLS" settlement it has effectively accepted the 6.5% on a prospective basis. Moreover, since the FCC's price cap formula and X-factor were based upon *total company* rather than separated interstate productivity experience, it is entirely reasonable for this Commission to apply this same 6.5% X-factor for intrastate services in Arizona.

Q. Given the differing treatment being afforded the three "Baskets" with respect to the applicability of the X-factor, is the *effective* productivity offset that is to be adopted under the Settlement Agreement even as high as the 4.2% that the Staff has calculated?

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18. (...continued)
6.2 percent for at least the first year in which the index is in effect. At the end of the first year, a change in the factor percentage shall be considered by the Commission upon a request for change in the productivity factor, X.

It is my understanding that Qwest is not opposing the adoption of this rule or the 6.2% X-factor.

A. No, it clearly is not. Under the Settlement Agreement, only "Basket 1" services would be subject to the operation of the X-factor. "Basket 2" rates would be frozen, and "Basket 3" rates would actually be allowed to rise by as much as 10% per year. Since we do not have an exact breakdown of the distribution of the Company's intrastate revenue among the three proposed "Baskets," we cannot make a precise calculation of the *effective X factor*. However, a hypothetical example will serve to illustrate this point.

Suppose that the revenue breakdown among the three Baskets (1/2/3) is 50%/25%/25%, respectively. Suppose further than the year-to-year increase in the GDP-PI is 2% (this is important for Basket 2, since the effective X-factor for Basket 2 equals the percent change in the GDP-PI). The effective X factor is calculated as shown in the following table:

Basket	Applicable X-factor	Revenue share	Weighted value
1	– 4.2%	50%	– 2.10%
2	– 2.0%	25%	– 0.50%
3	+ 10.0%	25%	+ 2.50%
EFFECTIVE X-FACTOR			– 0.10%

The Commission can, of course, perform the precise "effective X-factor" calculation by substituting the actual Basket revenue weights for the hypothetical values used in this example. Assuming, however, that the hypothetical values bear some general relationship to the (unknown) actuals (which I expect they do), this example demonstrates that when viewed comprehensively across all of the Company's intrastate services, the "productivity offset" all but vanishes under the Settlement Agreement's construct. Since even by its own data Qwest is experiencing total intrastate productivity growth in the range of 3.7%[19] (a value that is woefully understated), the adoption of an *effective X-factor* that is at or near zero will *by definition* result in pervasively excessive rate levels.

Q. One of the elements of the proposed Settlement Agreement calls for Qwest to provide an updated productivity study after two years, so that it can be considered as part of the "review" of the price cap plan that the Commission would undertake after the first three years of the plan's operation. Wouldn't that address your concern?

A. No. In the present case, Qwest has offered certain limited productivity data that produces a woefully inadequate estimate of Qwest's actual productivity growth rate. In addition to the various infirmities that I have already identified, the FCC has generally *rejected* the type of methodology employed by Staff using the Qwest data, and Qwest itself has accepted a substantially higher productivity offset in Utah, where an independent productivity study was performed by the staff, than it is proposing to accept here. There is no reason to believe that after two years Qwest will come forward with a study possessing any greater validity than the present one, or that the Staff will be in a position to undertake an independent study. Indeed, by employing a methodology that utilizes a

19. Response of the Arizona Corporation Commission Staff to AT&T Communications of the Mountain States, Inc.'s First Set of Data Requests AT&T1-001 dated October 19, 2000, at p. 3 of 4, *Average Productivity, 1995 - 1998* (SPR calculation).

revenue-weighted measure of output, which is Staff has done here, where some rates are decreasing as a result of the application of the 4.2% X-factor, it is entirely possible that the resulting productivity growth estimate will be even lower under this methodology than the 3.7% that Staff has calculated in this proceeding. Without a firm commitment for the Staff to develop an independent productivity growth estimate utilizing a methodology that has not been rejected by the FCC, that is based upon unseparated total company data, that incorporates an input price differential, and that will be applied across all studied services (monopoly as well as "competitive"), there is no assurance that after two or three years this Commission will be any closer to adopting an appropriate productivity offset than it is today.

Qwest will not be constrained by "marketplace forces" with respect to price increases for its "Basket 3" "competitive" services.

Q. In view of your concerns regarding potentially excessive rate increases in Basket 3, isn't it also true that the Company's ability to actually increase its "Basket 3" rates by as much as 10% annually (in addition to the $5-million increases in years 2 and 3 resulting from the corresponding decrease in switched access rates) will necessarily be constrained by marketplace forces?

A. That is clearly Qwest's claim, but in view of the Company's apparent willingness to accept a "settlement" in which nearly 60% of its revenue increase will come from so-called "competitive" services, it is highly unlikely that any such "marketplace"-driven constraint on Qwest price increases will actually be operative. In fact, one would normally expect that when competition arrives prices will *drop*, not rise. The very fact that Qwest expects to be able to *increase* its prices by as much as is contemplated in the Settlement Agreement undermines the Company's contentions as to the actual "competitiveness" of the so-called "competitive" services. While *some* of the "Basket 3" services may well confront actual competition sufficient to limit Qwest's ability to increase its prices for those services (what I have been referring to as "price-constraining competition"), there are, in fact, a number of "Basket 3" services that likely do not confront any such competition at all.

Q. To which "Basket 3" services in particular are you referring?

A. Local directory assistance and so-called "new" services that incorporate existing "Basket 1" basic services are prime examples. Others likely include single line ISDN Basic Rate Interface (BRI) service and Metropolitan Preferred Area Calling Service. In addition, by virtue of the fact that Qwest's *national* directory assistance service is accessed via the same '411' dialing pattern as its local DA service, coupled with the fact that Qwest does not offer the '411' dialing pattern to any other "competing" national or local directory assistance providers, I would also include national DA in my list of services that do not confront price-constraining competition. I will address this issue in more detail in my discussion of rate design issues later in this testimony.

Q. Why are you including Metropolitan Preferred Area Calling Service as a "competitive" service that does not confront actual price-constraining competition — isn't this service a form of intraLATA toll, which is competitive?

A. This service, also known as METROPAC, is an optional service that effectively extends its subscribers' local calling areas in certain selected exchanges. The price level for this service, which is at or less than five (5) cents per minute, is *substantially* below the 9 cents per minute switched access charge (covering both ends of each call) that would confront any competitor desiring to offer a comparable retail toll service. Consequently, there is no reasonable expectation that *any* competing interexchange carrier would undertake to offer a service competing with METROPAC that would necessarily have to be priced at roughly half of what the IXC would have to pay to Qwest for the underlying switched access services. Moreover, this condition will not change even under the proposed $5-million per year decreases in switched access charges because, at bottom, Qwest is not required to satisfy an imputation test for this service that incorporates the switched access rate. As I shall discuss below, this very same problem will arise under the proposed Settlement with respect to certain Basket 3 services.

The proposed reductions in switched access charges are insufficient and these rates should be subject to substantially larger reductions.

Q. Does the Settlement Agreement's plan with respect to reductions in switched access charges result in just and reasonable switched access rates?

A. No, it does not. Qwest-Arizona's intrastate switched access charge, at roughly 4.5 cents per minute per end (i.e., originating and terminating), is among the highest in the nation. By contrast, Qwest's *interstate* switched access charge is currently only about *half a cent* per minute per end.[20] In its original (pre-Settlement) testimony, Staff advanced the following specific proposal for reducing intrastate switched access charges:

> I propose that intrastate access prices be reduced by 20 percent per year from their initial levels so that by the end of the initial five year period [of the price regulation plan that was proposed in the initial pre-Settlement testimony] they are equivalent to U S WEST's interstate access charges at July 2000 levels. From that point on, I recommend that intrastate access charges be adjusted to "mirror" the interstate rates.[21]

This recommendation was both reasonable and generally consistent with the approach that has been adopted in the CALLS settlement, i.e., a five-year transition to cost-based access charges. It would, at the end of the transition period, essentially eliminate the existing disparity between Arizona intrastate and interstate switched access charges, and make it possible for intrastate toll (and particularly intraLATA toll) competition to develop to the same robust level that prevails in the case of interstate toll services.

Q. How has Staff modified its position in the Settlement Agreement?

A. Under the Settlement Agreement, switched access charges would be reduced by only $5-million per year, which amounts to a decrease of only 7.1% annually. At the end of

20. Stir (AT&T), Surrebuttal Testimony, Exhibit AS-1.

21. Shooshan (Staff), Direct Testimony, at 12.

three years, Arizona intrastate switched access charges will be 3.2 cents at each of the originating and terminating ends (i.e., 6.4 cents per minute for a two-ended call), whereas by that time the interstate counterpart will still be at 0.55 cents (i.e., 1.10 cents per minute for a two-ended call). The target interstate switched access rate of $0.055 cents closely reflects the underlying costs of providing this service, and of course there is no difference between the cost of providing intrastate and interstate switched access. On that basis, the existing 4.5 cent intrastate switched access rate is set approximately nine times its cost, and the 3.2 cent rate that will exist after the year 3 $5-million rate decrease will be six times the underlying cost. Neither the present nor the Settlement Agreement switched access rate level is economically reasonable, and the original Staff proposal should be substituted for the Settlement Proposal in order to assure just and reasonable access and intrastate toll rates.

Q. Will the specific proposal that the Settlement contemplates actually result in a $5-million decrease in access charge revenues in each of the three years?

A. No, the revenue decrease will be less than the amount stated in the Settlement Agreement. This is because when access prices are reduced, consumption will increase. In its *LEC Price Cap Order*,[22] the FCC adjusted the "raw" revenue effect of the annual price cap-based decrease in interstate switched access charges by applying a price elasticity factor for switched access services.

22. Federal Communications Commission, *Second Report and Order*, CC Docket No. 87-313, FCC 90-314, adopted September 19, 1990, released October 4, 1990 ("*LEC Price Cap Order*"), at Appendix C.

Q. What is the effect of adjusting the test year quantities revenue effect for demand stimulation?

A. I can best answer that by way of an example. If the price elasticity applicable to switched access is, say, –0.49, then when rates are reduced by $5-million based upon test year quantities, the increase in demand based upon the reduced price will result in an additional $2.45-million in access revenues. Thus, a $5-million reduction in access charges based upon test year quantities but without considering the effects of demand stimulation translates into a *net* revenue decrease of only $2.55-million. Put another way, if the goal is to reduce Qwest's access *revenues* by $5-million each year, then its *rates* will need to be reduced by $9.9-million to account for the additional $4.9-million in revenues arising from the stimulated demand for switched access.

The Settlement Agreement's rate design proposal will produce excessive and anticompetitive prices.

Q. Please summarize your understanding of the rate design plan that is incorporated into the proposed Settlement Agreement.

A. The Settlement contemplates different types of treatment for each of the three "Baskets" of services that are defined in the price cap plan. Basket 1 consists primarily of basic monopoly services; Basket 1 rates would be subject to a price cap based upon the GDP-PI – 4.2% formula. Certain Basket 1 services will see a rate increase, while others, such as the residential nonrecurring installation charge, will be reduced. Assuming that the economywide inflation rate remains at the same roughly 2% level at which it has been growing over the past decade or so, rates in this Basket can be expected to decrease by roughly 2% in each of the next two years. Basket 2 rates would not be subject to the PCI, but would instead be frozen at their existing levels, with the exception of switched access, which would be reduced by $5-million in each of the three years covered by the Settlement. The remaining Basket 2 services, consisting primarily of UNEs and wholesale services for resale, would not see any rate decreases. Finally, Basket 3 services would immediately be subject to an increase of up to $25.9-million, followed by additional increases of $5-million in each of years 2 and 3, to offset the $5-million in access charge reductions. Additionally, rates for Basket 3 services could be increased by up to 10% annually in each of years 2 and 3.

Q. What specific problems do you see with this proposal?

A. I have already indicated that the 4.2% X-factor is insufficient and, as a result, the year 2 and year 3 rate decreases that would be required for Basket 1 services will similarly be insufficient. There is a real problem with the Settlement's proposed treatment of Basket 2 rates. Basket 2 consists of services that are provided to competing carriers. In the case of UNEs and wholesale services provided for resale, rates would remain frozen while the *retail* prices for the *Basket 1* services to which these elements correspond would be subject to annual price cap index-based *rate decreases*. The result is a price squeeze, in that as the retail prices are reduced while the wholesale rates remain unchanged, the operating *margin* between the two will necessary shrink, eroding competitors' profits and potentially making it impossible for them to compete.

To see how the price squeeze would operate, consider the following example. Suppose that the retail price of a service is $20 and that the wholesale price is currently $17.60, i.e., 12% less than the retail price. Assuming a 2% inflation rate, the following table summarizes the price levels that would be in effect for the retail and wholesale services over the three-year term of the price cap plan:

Year	Retail price	Wholesale price	Operating Margin
1	$ 20.00	$ 17.60	$ 2.40
2	$ 19.56	$ 17.60	$ 1.96
3	$ 19.12	$ 17.60	$ 1.52

Note that, in this example, the relatively modest 4.4% decrease in the *retail* price as between years 1 and 3 results in a whopping *36% decrease* in competitors' operating margin over that same period, i.e., from $1.20 initially to only $0.76 in the third year.

Q. Are there any other issues relating to the price freeze applicable to Basket 2?

A. Yes. Section 252(d)(3) of the federal *Telecommunications Act of 1996* establishes the pricing rule for wholesale services that are provided to resellers:

> Sec. 252(d)(3). WHOLESALE PRICES FOR TELECOMMUNICATIONS SERVICES- For the purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

These "marketing, billing, collection, and other *costs*" can be expected to experience the same productivity growth as the *retail* services in Basket 1 (and, indeed, as I have noted, the X-factor calculation *includes* Basket 2 as well as Basket 3 services), yet the Settlement Agreement would deny the benefits of those efficiency gains to the unambiguously monopolistic wholesale and UNE services.

Q. As an economist, do you believe that the proposed treatment of Basket 2 services is consistent with the provisions of the *Telecommunications Act*?

A. No, I do not. While I am not an attorney and hence do not offer a legal opinion, the plain language and intent of the federal statute appears at odds with the proposed treatment of Basket 2 services. First, the disparate treatment of Basket 1 retail services and Basket 2 wholesale services with respect to the application of the PCI would, in my view, violate Section 252(d)(3), which *requires* that the wholesale price be set at the retail price *less avoided retailing costs*. There is no basis to believe or expect that the retailing costs that will be avoided will decline by the magnified amount that would arise as a result of this disparate treatment. Second, with respect to UNEs, Section 252(d)(1) requires that prices for UNEs "(A) shall be (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and (ii) nondiscriminatory, and (B) may include a reasonable profit." UNE costs are required to be based upon Total Element Long Run Incremental Cost (TELRIC).[23] For any given UNE, TELRIC studies are conducted periodically, not continuously. As with wholesale services, there is simply no reason to expect that the same productivity growth that will be experienced with respect to retail (Basket 1) services will not also apply with respect to UNEs. By failing to reflect the same productivity offset with respect to UNE prices, the Settlement Agreement discriminates against competing providers and subjects them to an anticompetitive price squeeze.

Q. Are there any other problems with the manner in which Basket 2 services are to be priced?

A. Yes. This concerns the relationship between Basket 2 and Basket 3 prices that would arise under the Settlement Agreement. One of the provisions of Basket 3 is that the Company will be permitted substantial pricing flexibility with respect to Basket 3 services, including the right to offer geographically differentiated rates. In fact, the only specific constraint that would be imposed upon Basket 3 prices is that such geographical pricing cannot have the effect of "red-lining" with respect either to race or wealth.[24]

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23. Federal Communications Commission, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers,* CC Docket Nos. 96-98 and 95-185, *First Report and Order* released August 8, 1996, para. 672, 47 CFR § 56.05.

24. Settlement Agreement at 6.

There is nothing to prevent Qwest from, from example, offering lower prices wherever a competitor has elected to offer service. In fact, since only the *overall* price level of Basket 3 services is subject to any sort of rate cap, Qwest would actually be permitted under the Settlement to lower prices for those Basket 3 services that confront actual, price-constraining competition while simultaneously offsetting these price decreases with price *increases* imposed upon customers who do not confront actual competitive choices. As long as the *average* price change *taken over all Basket 3 services* does not violate the 10% annual Basket 3 price cap increase constraint, such tactics would be permissible under the Settlement. The effect of this disparate treatment would be to create a cross-subsidy flowing from non- or minimally-competitive Basket 3 services to actually competitive Basket 3 services, which would directly violate Section 254(k) of the federal *Telecommunications Act* as well as A.A.C. R14-2-1109(C).

At the same time, Basket 2 wholesale and UNE rates would be frozen, which means that situations may well arise where the *retail* prices of some Basket 3 services (and, in particular, those that confront actual competition) could be set *below* the Basket 2 price for the underlying wholesale service or UNEs. Section 251(c)(4)(A) of the *Telecommunications Act* imposes upon Qwest the duly "to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers." Hence, the possibility exists that the Basket 2 wholesale price could actually *exceed* the Basket 3 retail price or otherwise fail to reflect retailing costs that will be avoided when the service is furnished for resale, which would in my view violate the requirements of Section 252(d)(3).

Q. Are there any other concerns associated with the proposed treatment of Basket 3 services?

A. Yes. The Settlement Agreement permits Qwest to define "new" Basket 3 services that incorporate one or more Basket 1 services. By so doing, the Basket 3 service would be removed from the application of the price cap index, and would be subject to pricing flexibility. The only caveat that would apply to the pricing of the Basket 3 service is that if it incorporates 1FR (single-party residence flat-rate) service, the price of the Basket 3 offering cannot fall below the Basket 1 1FR rate.[25] Other than this one limitation, there is no imputation requirement applicable to Basket 3 services that incorporate one or more Basket 1 services. That means that Qwest could create "new" Basket 3 offerings that would not only fall below the prices for the underlying Basket 2 wholesale and UNE prices, but even fail to fully reflect the tariffed rate for the incorporated Basket 1 services. Under these circumstances, there is no reasonable prospect for the development of competition for such services. Add to that the ability to offer geographically-specific rates, and Qwest gets the ability to surgically "take out" any competition that might actually arise.

Moreover, while in theory all of the services that have been reclassified as "competitive" pursuant to A.A.C. R14-2-1108 have been placed in Basket 3, the Settlement Agreement does not *require* that such classification be approved for Basket 3 services and, indeed, explicitly permits Qwest to place "new" services or service "packages" into Basket 3

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25. Settlement Agreement, Attachment A, Part 4.e.

without a Commission finding classifying such services as "competitive" under A.A.C. R14-2-1108. The effect of this provision of the Settlement Agreement is to eviscerate A.A.C. R14-2-1108 by affording the very same type of pricing flexibility to *all* Basket 3 services and, even worse, affording the Company the ability to engage in cross-subsidization *among* those Basket 3 services that have been officially reclassified pursuant to A.A.C. R14-2-1108 and those "new" services and service "packages" that have not. A.A.C. R14-2-1109(C) expressly prohibits such cross-subsidization, requiring that "[a] competitive telecommunications service shall not be subsidized by any rate or charge for any noncompetitive telecommunications services." Under the terms of the Settlement Agreement, such intra-Basket 3 cross-subsidization would be both possible and virtually undetectable. Moreover, to the best of my knowledge, in each and every case where Qwest has requested and received A.A.C. R14-2-1108 reclassification for a particular service, the evidence, such as it was, that was offered by the Company in support of its application was aggregated across the entire state, effectively *concealing* those communities in which no effective competitive alternative(s) for the subject service(s) was(were) available to customers as a practical matter. The presence of geographically selective competition coupled with *statewide* reclassification would clearly give Qwest the ability, under the Settlement Agreement, to discriminate against customers of Basket 3 services that do not confront actual competition by raising their prices while reducing those for which actual competition is present, and in so doing work to potentially eliminate competition even in those areas in which it has arisen or might arise. At the very least, the Commission will need to revisit its prior classification of services as "competitive" and reject outright any attempt to include services not so classified in

Basket 3. There is, in fact, no obvious basis under applicable statutes for the *automatic* assignment of all "new" services, including and especially those that are little more than a repackaging of existing Basket 1 monopoly services, into Basket 3.

Q. You had previously questioned the treatment of directory assistance (DA) as a Basket 3 service. Please explain the basis for your concern.

A. In my direct testimony at 28-33, I discussed the problem with the proposed collapsing of local DA into Qwest's national DA offering. While the Commission had previously determined that the local and national DA offerings satisfy A.A.C. R14-2-1108 and therefore should be classified as "competitive," local DA is currently *bundled* into basic exchange service (with respect to the first call each month) and the existing 47 cent charge for additional *local* DA calls continues to apply. Qwest's local DA service is accessed by dialing the familiar '411' sequence, and the Company has designed its "competitive" national DA service to also be accessed in exactly this same manner. Moreover and more importantly, while claiming that DA service is "competitive," Qwest does not offer or otherwise make available the same '411' dialing pattern to competing DA service providers. Section 251(b)(3) of the *Telecommunications Act* imposes upon all local exchange carriers

> The duty to provide dialing parity to competing providers of telephone exchange service and telephone toll service, and the duty to permit all such providers to have nondiscriminatory access to telephone numbers, operator services, directory assistance, and directory listing, with no unreasonable dialing delays.

Section (3)(a)(2)(39) defines "dialing parity" as follows:

> The term 'dialing parity' means that a person that is not an affiliate of a local exchange carrier is able to provide telecommunications services in such a manner that customers have the ability to route automatically, without the use of any access code, their telecommunications to the telecommunications services provider of the customer's designation from among 2 or more telecommunications services providers (including such local exchange carrier).

If directory assistance is a "competitive" service, then Qwest is *obligated* to offer '411' access to competing providers of directory assistance service. Its failure to do so is, in my view, a basis for reclassifying *all* directory assistance as a "monopoly" service to be included within Basket 1. The Settlement Agreement ignores my prior testimony on this point and entirely sidesteps this issue.

A settlement that adequately reflects the various concerns expressed here is possible, and if the Commission determines that a settlement should be pursued, the Settlement Agreement should be modified accordingly.

Q. Given the numerous concerns you have expressed with respect to the proposed Settlement, do you believe that the Commission should nevertheless pursue a settlement rather than continue with litigation of this case?

A. I believe that the Commission can consider modifying the proposed Settlement Agreement to reflect both the evidence presented in this proceeding and, more specifically, the various concerns that I have been discussing here. However, if Qwest and/or the Staff resist acceptance of these modifications, it is my recommendation that the Commission reject the Settlement Agreement and resume litigation.

Q. What specific modifications would you recommend?

A. I recommend that the following changes be made in the Settlement Agreement:

(1) The $42.9-million revenue increase should be changed to a rate decrease in the amount being recommended by Ms. Gately.

(2) The price cap plan should be modified as follows:

- The X-factor should be changed to 6.5%, the level that has been adopted by the FCC, or at the very least should be changed to 6.2%, the level that Qwest had itself agreed to in the Utah settlement.

- Inasmuch as the productivity growth has been calculated using operating data embracing all three Baskets, the X-factor should be applied to all three Baskets.

- The same wholesale discount should apply to all retail services, including those in Basket 3 and including those that are subject to geographically-differentiated pricing.

- Staff should commit to performing an independent productivity study in sufficient time to be considered in the price cap review proceeding, and should base its study upon the methodology that has been adopted by the FCC in its

Price Cap Performance Review Fourth Report and Order.[26] The productivity should include an input price differential to reflect the significantly lower rate of cost inflation being experienced by LECs with respect to their input prices vs. the economywide inflation rate as reflected in the GDP-PI. Alternatively, if the X-factor is to be applied solely to "monopoly" Basket 1 services, productivity should be confined to operating results applicable solely to those services.

(3) Switched access charges should be reduced annually until they reach parity with the interstate switched access rate level. In calculating the revenue effect of the access charge reduction, a price elasticity factor should be applied to account for the resulting demand stimulation that will result from the lower prices.

(4) Rates for Basket 2 services should maintain the same relationship with retail Basket 1 and Basket 3 rates so as to avoid a price squeeze for competing service providers and to comply fully with applicable federal law and regulation.

(5) Directory assistance should remain a monopoly Basket 1 service unless and until Qwest undertakes to provide '411' dialing parity to competing DA service providers.

(6) The Commission should not permit any "new" services or service "packages" to be placed in Basket 3 unless and until the Commission finds that such services or packages satisfy A.A.C. R14-2-1108.

26. *Op. cit.*, footnote 4.

(7) Any "new" services or service "packages" that are created out of one or more existing Basket 1 services and are then placed in Basket 3 should be subject to a full imputation test, with the floor price to be set at the full retial tariffed rate for the incorporated Basket 1 services plus the TSLRIC of any additional components of the "new" service that are incremental to the underlying Basket 1 elements.

Q. Does this conclude your supplemental direct testimony at this time?

A. Yes, it does.

Attachment 1

Replication of Staff Productivity Study Utilizing "Unadjusted" Qwest Revenue Data

ECONOMICS AND TECHNOLOGY, INC.

Attachment 1 Qwest-Arizona Productivity Study Based Upon Unadjusted Revenues

Arizona Productivity Analysis 1994-1998
($000)

INPUTS

Line No.	Item	Source	1994	1995	1996	1997	1998*
1	Intrastate Expenses						
2	Maintenance	1990's Report	179,310	187,774	205,041	200,848	206,061
3	Engineering/Network/Access/Other	1990's Report	689,190	71,773	65,179	48,964	52,927
4	Customer Operations	1990's Report	140,269	153,528	161,304	172,445	164,816
5	Corporate Operations	1990's Report	120,992	116,448	127,985	143,530	155,888
6	TOTAL EXPENSE		509,481	529,521	559,509	565,787	579,692
7	DEFLATED EXPENSE (1998 $)	L6/GNPPI	418,433	423,617	438,274	433,369	439,731
8	YEAR OVER YEAR GROWTH			1.2%	3.5%	-1.1%	1.5%
	CAPITAL - Intrastate Investment						
9	Average Gross Plant in Service	1990's Report	2,748,270	2,896,085	3,075,298	3,249,626	3,351,980
10	Year Over Year Additions	L9 Curr. Yr.-Prev. Yr.		147,815	179,213	174,328	102,354
11	Deflated Additions (1998 $)			118,252	140,381	133,528	77,642
12	Plant in Service Without Inflation	L11+Prev. Yr. L12	2,839,976	2,758,228	2,898,609	3,032,137	3,109,778
13	Auth Rate of Return		9.75%	9.75%	9.75%	9.75%	9.75%
14	TOTAL CAPITAL EXPENSE	L12*L13	257,398	268,927	282,614	295,633	303,203
15	YEAR OVER YEAR GROWTH			4.5%	5.1%	4.6%	2.6%
16	TOTAL EXPENSE	L7+L14	675,831	692,544	720,888	729,002	742,935
17	YEAR OVER YEAR GROWTH			2.5%	4.1%	1.1%	1.9%

OUTPUTS

Line No.	Item	Source	1994	1995	1996	1997	1998*
18	REVENUES						
19	Operating Revenues	1990's Report	813,423	884,920	961,388	1,017,826	1,072,695
20	Rate Adjustments		0	0	0	0	0
21	TOTAL ADJUSTED REVENUES	L19+L20	813,423	884,920	961,388	1,017,826	1,072,695
22	YEAR OVER YEAR GROWTH			8.8%	8.6%	5.9%	5.4%
23	Growth in Outputs (Revenues)			8.8%	8.6%	5.9%	5.4%
24	Growth in Inputs (Expenses)			2.5%	4.1%	1.1%	1.9%
25	Productivity			6.3%	4.5%	4.7%	3.5%

AVERAGE PRODUCTIVITY 1994-1998 **4.8%**

*1998 based on Septmeber 1998 YTD results annualized

*Based Upon Shooshan Methodology. Direct Testimony of Harry Shooshan III, August 9, 2000 p. 13

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AZ CORP COMMISSION
DOCUMENT CONTROL

Before the

ARIZONA CORPORATION COMMISSION

In the Matter of the Application of US West Communications, Inc., a Colorado Corporation, for a Hearing to Determine the Earnings of the Company, the Fair Value of the Company for Ratemaking Purposes, to Fix a Just and Reasonable Rate of Return thereon and to Approve Rate Schedules Designed to Develop Such Return	**Docket No. T-1051B-99-0105**

Supplemental Direct Testimony

of

SUSAN M. GATELY

on behalf of

AT&T COMMUNICATIONS
OF THE MOUNTAIN STATES, INC.

November 13, 2000

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SUPPLEMENTAL DIRECT TESTIMONY

Introduction

Q. Please state your name, position and business address.

A. My name is Susan M. Gately. I am the Senior Vice President of Economics and Technology, Inc., (ETI), One Washington Mall, Boston, Massachusetts.

Q. Are you the same Susan M. Gately that testified earlier in this same proceeding?

A. Yes. I prepared direct testimony that was filed on August 8, 2000 and surrebuttal testimony that was filed on September 8, 2000.

Q. What was you assignment relative to the Settlement Agreement?

A. Economics and Technology, Inc., has been asked by AT&T Communications of the Mountain States, Inc. (AT&T) to evaluate and make recommendations relative to the Proposed Settlement agreed to by Qwest Corporation (Qwest) and the Commission Staff (Staff). My testimony addresses the various revenue adjustments that have been incorporated into the Settlement Agreement; Dr. Lee Selwyn is also sponsoring testimony addressing the price cap regulation plan and the various rate design issues that are incorporated into the Settlement Agreement.

Q. What is the purpose of your testimony at this time?

A. The purpose of my testimony is to demonstrate that the $42.9-million revenue increase that would be allowed by the Settlement Agreement is neither reasonable nor in the public interest. I shall demonstrate that the Settlement Agreement ignores the ample evidence that was presented in this proceeding that Qwest should be subjected to a substantial revenue requirement *decrease*, not an increase. Moreover, the methodology that was employed by Staff and Qwest to get to that $42.9-million number can only be described as arbitrary and began from an unreasonably inflated revenue requirement base. If, and to the extent the Commission decides to adopt a decision based upon the settlement approach used by Staff and Qwest (a "split the baby" approach), that same "split the baby" treatment must be accorded to the proposed adjustments of other interested parties as well.

Q. Is the impact of the level of rates coming out of this negotiated settlement influenced in any way by the concurrent implementation of the price caps form of regulation also embodied in the Settlement Agreement?

A. Yes, in fact the impact of the Settlement Agreement's failure to properly reduce rates is compounded by the coupling of the *negotiated* $42.9-million revenue increase with the institution of a price cap form of regulation. Central to any *price regulation* plan is the presumption that the going-in price levels are just and reasonable. Implementing a price regulation plan while ignoring evidence that the present price levels result in *overearnings* for Qwest does a disservice to all of Arizona's ratepayers, both end users as well as competitive service providers that must purchase Qwest's wholesale offerings in order to offer their own competing services.

Q. Should the Commission be concerned with the full $42.9-million increase being allowed by the Settlement Agreement, inasmuch as only $17.6-million of the $42.9-million in authorized rate increases will affect core monopoly services, with the remaining $25.3-million being left for increases in prices for competitive services at Qwest's discretion?

A. Yes. In fact, Qwest's willingness to participate in a Settlement in which roughly 60% of the authorized revenue increase is comprised of "headroom" in Basket 3, where services have been declared "competitive," demonstrates many of the problems with the Settlement Agreement. If the services in Basket 3 are actually subject to viable economic competition, then Qwest's ability to raise prices in that basket to generate an additional $25.3-million ($35.3-million over the first 3 years) should be severely limited by that competition. Qwest's willingness to limit the recoupment of this revenue from *voluntary* increases to the Settlement Agreement's Basket 3 Services means one of two things: If Qwest's intent is to raise prices in Basket 3 by $25.3-million, then clearly viable competitors do not exist for the services classified as Basket 3 and those services are improperly classified; here "market" forces cannot be relied upon to regulate price levels. Alternatively, if Qwest does not intend to raise prices in Basket 3 to recoup those revenues, it corroborates the evidence provided by AT&T and other parties that the revenue requirement results presented by Qwest in this proceeding are grossly inflated, and that in fact Qwest's prices should be reduced.

Recall that Qwest's original request revealed a *$201-million revenue shortfall*, of which Qwest sought recovery of $89-million. If the Basket 3 services are truly competitive (in which case Qwest will not be able to recover the $25.3-million) it strains credibility that Qwest would willingly settle for less than 10% of the revenue shortfall it originally identified without even taking its case to the Commission.[1]

The method that was used to develop the $42.9-million "negotiated" revenue increase incorporated in the Settlement Agreement was arbitrary and gave undue credit to Qwest's initial estimate of a $201-million revenue requirement shortfall in Arizona.

Q. How did Staff and Qwest arrive at the $42.9-million revenue increase result included in the Settlement Agreement?

A. The very limited testimony of both Qwest and Staff witnesses filed in support of the revenue increase included in the Settlement Agreement is quite unapologetic about the fact that a "split the baby" approach was used to negotiate a revenue increase. Although very little testimony was provided in support of the $42.9-million increase, what was provided made it quite clear that the negotiation did not take into consideration the merits of any of the adjustments proposed by Staff.

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1. In point of fact, if Qwest's original revenue requirement result had any validity at all, it could be argued that Qwest was not fulfilling its responsibility to its shareholders by participating in the Settlement Agreement.

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Essentially, it appears that Staff and Qwest simply met and reviewed the differences between the numbers underlying Qwest's initial submission of data revealing a $201-million revenue shortfall and any adjustments to the data in that initial Qwest submission that were proposed by Staff in its Direct Testimony. Any Staff proposals that directly mirrored issues decided by this Commission in the immediately previous rate case proceeding were adopted (e.g., the rate of return). Any remaining adjustments to Qwest's initial $201-million revenue shortfall proposal made by Staff, adjustments that involved issues that had not arisen in the last rate case (which made up the bulk of Staff's proposed adjustments) were split down the middle. Redding describes the development of the agreed upon "income available from operations" (a critical component of the development of a revenue requirement, and the subject of most of Staff's proposed adjustments) as follows:

> Again, this was the product of negotiations. In discussions related to issues, the parties generally followed the disposition of the issues in the last rate case, Docket No. E-1051-93-183. ... there were several adjustments discussed during the negotiations. ... These issues were either not at issue in Qwest's last rate case, or contrary to the outcome found by the Commission in the last proceeding. ... The parties agreed to an income available from operations that was not based upon a compellation [sic] of specific adjustments. Rather, it was the product of mutual agreement using the adjusted net operating income shown on Staff Schedule A and approximately one half the value of the adjustments described above.[2]

Staff witness Brosch describes a similar process.[3]

2. Redding at 3 to 4.

3. Brosch at 1 to 3.

Q. Why do you describe this method as giving undue credit to Qwest's initial $201-million revenue shortfall estimate?

A. The methodology used to develop the negotiated revenue increase begins with an analysis of the *differential* between Qwest's estimated revenue requirement, and the revenue requirement calculated by Staff. Therefore, as a necessary outcome of the methodology, the more overstated the revenue requirement shortfall identified in Qwest's initial study, the larger the "negotiated" increase coming out of the Settlement Agreement. This occurs for the two reasons described below.

- First, since the "split the baby" approach ignores the merits of the various adjustments proposed by Staff, Qwest is automatically awarded 50% of the revenue requirement component included in its initial revenue shortfall estimate -- regardless of how unreasonable or unlawful a particular component may be.[4]

- Second, the "split the baby" approach used in the Settlement was applied only to adjustments proposed by Staff, to the extent that Staff overlooked any adjustments that should legitimately have been made to Qwest's numbers (e.g., adjustments that may have been proposed by other parties but not by Staff) those adjustments didn't get accounted for at all.

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4. As mentioned above, the fact that Qwest identified $201-million in revenue shortfall, but only sought recovery of $89-million, immediately raises questions about the credibility of the $201-million shortfall.

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Q. Can you provide a hypothetical example to illustrate the mechanics of this point?

A. Certainly. Consider the following hypothetical:

- Qwest's initial study reveals a $301-million revenue requirement shortfall in place of the $201-million in the actual Qwest study;
- The additional $100-million in revenue requirement was associated with a new Qwest initiative to lease and operate individual aircraft and vacation villas in the Caribbean for the personal use of its executives in Arizona;
- Upon review of Qwest's study the Staff proposed an adjustment to disallow this expense (an adjustment that did not have a corollary in the last rate case because Qwest wasn't providing aircraft and Caribbean vacation villas to its executives at that time).

Under such a scenario, all else being equal, the methodology used to arrive at the "negotiated" increase would have allowed $50-million of the additional $100-million associated with the aircraft and vacation villas, resulting in a revenue requirement $50-million greater than the $49.2-million in Settlement Agreement today.

If we change the last assumption of the hypothetical, and assume that Staff did not discover the aircraft / vacation villa expenses in the Qwest documentation, then the entire $100-million in revenue requirement would have been incorporated into the negotiated increase *even if one of more other intervenors had identified the problem and proposed an adjustment.*

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Q. What do you recommend this Commission do?

A. If, and to the extent that, the Commission determines that it is appropriate to determine the outcome of this case through Settlement negotiations rather than fully litigating the issues in dispute, then any revenue adjustment flowing out of a Settlement must treat equally proposed adjustments of all of the parties to the proceeding. Meaning that any corrections to Qwest's revenue requirement estimate made by other parties that are not duplicative of adjustments proposed by Staff should be accorded the same "split the baby" treatment as was used for the Staff and Qwest estimates.

The Settlement Agreement ignores all of the corrections to Qwest's reported expenses and rate base identified by AT&T that were not also recommended by Staff.

Q. Does the $42.9-million rate increase allowed by the Settlement Agreement incorporate the adjustments to expenses or rate base that were specifically identified by AT&T during the course of this proceeding?

A. No, for all but a few or the smaller adjustments, it does not. In my Direct Testimony, I demonstrated that Qwest had grossly inflated its revenue requirement by overstating both telephone plant investment and operating expenses. The "negotiated" revenue requirement level produced as a result of the Settlement Agreement ignored all of the overstatements and legitimate corrections identified in my Direct Testimony. The failure to account for most of the rate base and operating expenses identified in my Direct

Testimony results in a Settlement Agreement that allows Qwest not only to continue overearning, but to increase the extent of that overearning.

Q. Can you identify and quantify specific corrections to the level of rate base and expenses reported by Qwest that have been ignored in the development of the negotiated revenue requirement?

A. Yes. There were nine specific corrections identified in my Direct Testimony, seven of which were not addressed by Staff and Qwest in the development of the negotiated revenue increase. In total, those seven adjustments would lower Qwest's rate base by $237.5-million (i.e., 16% of the "fair value rate base" agreed upon by Staff and Qwest in the Settlement Agreement). The combined impact of my seven unaccounted for recommended expense disallowances and revenue imputation recommendations upon "income from operations" would be an increase of PROPRIETARY<<$ - >>END PROPRIETARY, dwarfing the "negotiated" increase in revenue included in the settlement.[5] The seven adjustments that I had identified in my Direct Testimony, and that were not incorporated into the Settlement Agreement, are as follows:

(1) The negotiated revenue increase does not account for elimination of Qwest's improperly included capital investment and expenses associated with the FCC's ordered implementation of Local Number Portability (LNP) as discussed at pages 9-

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5. This amount includes imputation of the full amount of Arizona yellow pages revenue originally identified in Dr. Selwyn's testimony.

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17 of my Direct Testimony. My testimony demonstrates that Qwest's capital costs (rate base) is inflated by $40.6-million and expenses by $6.6-million as a result of improper accounting for LNP implementation.

(2) The negotiated revenue increase does not account for elimination of Qwest's improperly included interconnection costs (extraordinary and nonrecurring start-up costs associated with facilitating competition in accordance with the requirements of the federal *Telecommunications Act of 1996* (the "96 Act")). As is documented in my Direct testimony at page 17 -22, consistent with the logic employed by the Utah PSC in a recent decision,[6] this Commission should disallow the $38-million in capital costs and $31.8-million in expenses associated with the implementation of interconnection.

(3) The negotiated revenue increase does not reflect the recommendation at pages 22-28 of my Direct Testimony and at pages 62-91 of Dr. Selwyn's Direct Testimony to incorporate the full complement of rate base and expense adjustments associated with the findings of the FCC's Accounting and Audits Division's Continuing Property Records (CPR) Audits. My Direct Testimony documents a recommendation for $78-million in rate base reductions and $8.1-million in expense reductions that was ignored by Staff and Qwest in the development of the Settlement Agreement's

6. In the Matter of the Request of U S WEST Communications, Inc. for Approval of an Increase in its Rates and Charges, Utah Docket No. 97-049-08, Report and Order issued December 4, 1997, p. 17.

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negotiated revenue increase. Staff had recommended no rate based reductions, and only $1.7-million in expense reductions[7].

(4) The negotiated revenue increase ignores the recommendation at pages 29 - 31 of my Direct Testimony to remove 50% of the net investment and losses from deregulated services: this is equal to $9.8-million in net investment and $.6-million in operating income.

(5) The negotiated revenue increase does not account for the continued imputation of yellow pages revenues to Arizona intrastate operations in the manner recommended at pages 31-34 of my Direct Testimony. The Settlement Agreement would appear to incorporate either the full amount of Staff's recommendation to continue imputation at the $43-million per year level agreed upon in the 1988 Settlement[8]. It does not make any account the full recommended imputation found in my Direct Testimony in the amount of PROPRIETARY<< >>END PROPRIETARY based upon the discussion and calculations found at pages 92-118 of Dr. Selwyn's testimony. This difference between the minor $43-million adjustment that may have been accounted for in the Settlement and the full amount I recommended alone would eliminate the need for any increase in Qwest's revenues whatsoever.

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7. ACC Staff Joint Accounting Exhibit, Schedule E, lines B-1 and C-22.

8. The Settlement Agreement reached between the Commission and U S WEST in 1988, which was approved in Decision No. 56020, requires imputation, or inclusion, of approximately $43-million of revenue into U S WEST's revenue requirement calculation for rate making purposes.

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(6) The negotiated revenue requirement does not account for my recommended elimination of a $66-million increase in rate base made by Qwest associated with the creation of a pension asset from prior periods over-funding and described at pages 34-35 of my Direct Testimony. Staff had recommended removing only $42.3-million[9] of the $66-million I had recommended, leaving $23.9-million unaddressed.

(7) The negotiated revenue increase does not account for a recommended $5.5-million rate base reduction and $16.6-million expense reduction discussed at pages 36-37 of my Direct Testimony. I recommended disallowance of a Qwest adjustment associated with switching to an accrual method of accounting for Post-retirement Benefits Other than Pension (PBOPs) based upon my finding that Qwest had not met one of this Commission's enumerated preconditions for adopting such accounting treatment.

Q. What is the basis for your statement that Qwest and Staff have ignored your recommended rate base and expense adjustments in "negotiating" the rate increase incorporated into the Settlement Agreement?

A. Review of the method used by Qwest and Staff to "negotiate" a revenue increase amount as detailed in the Testimony of Qwest witness Redding and Staff witness Brosch, reveals that only those adjustments proposed by Staff were incorporated into developing the $49.2-million result. Therefore, unless an adjustment proposed by an intervenor was also proposed by Staff, it was not incorporated into the $49.2-million. To the best of my

9. Carver Direct at 116.

understanding, the none of the "contested" adjustments (to which the 50% split was applied) specifically enumerated by Brosch in his testimony overlap with the adjustments recommended in my testimony and described above. Additionally, my review of the initial Staff recommendations that may have fallen into the accepted category (because they relied upon the disposition of the issue in the most recent Commission rate case decision), revealed overlap only to the extent discussed above.

Q. Would it be possible to apply the same treatment used to "negotiate" the difference between Staff's initial recommended revenue requirement adjustments and Qwest's revenue requirement results as initially filed to the recommendations made in your Direct Testimony?

A. Yes.

Q. Would it be appropriate to do so?

A. Yes. As I discussed above, the method used to come up with the $49.2-million revenue increase agreed to by Staff and Qwest is unquestionably arbitrary. However, if this Commission makes a determination to proceed using an admittedly arbitrary method of resolving the differences between the proponent of the rate increase (Qwest) and those disputing the Qwest results (all other intervenors) that is based not upon the merits of the positions being advocated, but rather upon a "splitting of the differences", then that splitting of the differences must be applied to the "differences" identified by all of the parties, not just Staff-identified differences.

Treating the adjustments to Qwest's initial $210-million revenue requirement shortfall estimate proposed by AT&T in the same manner as the Staff-identified adjustments reveals that Qwest is substantially overearning, and that revenues should be reduced, not increased.

Q. Have you calculated the impact of treating the "differences" between Qwest and AT&T in the same manner as the "differences" between Staff and Qwest were handled during the negotiation of the Settlement Agreement?

A. Yes, I have. My calculations demonstrate that treating the differential between the adjustments recommended in my Direct Testimony and Qwest's initially filed results in this same manner, and adding those changes to the changes found in the Staff/Qwest Settlement Agreement, would which would require a *reduction in rates of PROPRIETARY<<* *>>END PROPRIETARY* rather than the $42.9-million *increase* negotiated by Staff and Qwest in the Settlement Agreement. The table below begins with the same data presented both by Staff witness Brosch and Qwest witness Redding documenting the "negotiated" Settlement Values (in $-millions) adding two columns that lead to the development of a revised revenue adjustment figure. The first column contains 50% of the value of the recommended rate base and net operating income adjustments found in my Direct Testimony that were ignored by Staff and Qwest in the development of the agreed upon "negotiated" Settlement Agreement values. In the second column, these amounts are added to the "Settlement Values" to allow calculation of new revenue requirement adjustment.

Calculation of Revenue Requirement by Applying Staff/ Qwest Negotiating Method to AT&T Proposed Changes

Settlement Values	Staff/Qwest Settlement	AT&T Adjustment(50%)	Revised Results
Fair Value Rate Base	$ 1,445.8	$ 118.8	$ 1,325.0
Fair Rate of Return	9.61%		9.61%
Required Operating Income	$ 138.9		$ 127.5
Adj. Net Operating Income	$ 113.7	PROP<< >>ENDPROP	PROP<< >>ENDPROP
Operating Income Shortfall	$ 25.2		PROP<< >>ENDPROP
Gross Rev. Conv. Factor	1.6995		1.6995
Total Change in Rev. Req.	$ 42.9		PROP<< >>ENDPROP

Q. In the context of evaluating the Settlement Agreement, would it be appropriate for this Commission to accord the revenue requirement adjustments detailed as necessary in your Direct Testimony the same treatment were accorded those proposed by Staff?

A. As I discussed above, if and to the extent that the Commission makes a determination that "negotiation" of the differences between parties' revenue requirement positions offers a more appropriate disposition of those issues than litigation of the differences as contemplated in the more traditional rate format, then it is absolutely appropriate to treat the revenue requirement positions of all of the parties in the same manner.

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Q. Qwest and Staff indicated that they evaluated the "litigation risk" of having the Commission rule upon the Staff proposed adjustment. Have you calculated the potential impact of litigating the revenue requirement adjustments identified in your direct testimony assuming that your recommendations are adopted in all cases by this Commission?

A. Yes, I have. My calculations demonstrate that rather than requiring an *increase* in revenues of $42.9-million, a revenue requirement reduction of PROPRIETARY<< >>END PROPRIETARY-million would be necessary for Qwest. The table below mirrors the one presented above, with the replacement of the full amount of my proposed revisions in place of the 50% used for the Staff recommendations to arrive at the Staff/Qwest Settlement Agreement.

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Calculation of Revenue Requirement by Assuming Adoption of All AT&T Proposed Changes

Settlement Values	Staff/Qwest Settlement	AT&T Adjustments	Revised Results
Fair Value Rate Base	$ 1,445.8	$ (237.6)	$ 1,208.2
Fair Rate of Return	9.61%		9.61%
Required Operating Income	$ 138.9		$ 116.1
Adj. Net Operating Income	$ 113.7	PROP<< >>ENDPROP	PROP<< >>ENDPROP
Operating Income Deficiency	$ 25.2		PROP<< >>ENDPROP
Gross Revenue Conv. Factor	1.6995		1.6995
Total Change in Rev. Req.	$ 42.9		PROP<< >>ENDPROP

Q. Does this conclude your supplemental testimony at this time?

A. Yes, it does.

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